FRBSF Weekly Letter
July 5, 1985

Deficit Projections vs. Deficit Forecasts

The outlook for the federal government budget deficit over the remainder of the decade has received considerable attention in the press, in the most recent Presidential election campaign, and in discussions of appropriate economic policies. The data forming the basis for these discussions are usually deficit projections similar to those prepared each year by the Congressional Budget Office (CBO) and the Office of Management and Budget (OMB).

Both of these agencies are required, under the terms of the Congressional Budget Act of 1974, to construct medium-term projections of federal receipts, outlays and deficits. These projections are constructed for the limited purpose of providing a benchmark against which proposals for changes in federal outlays or taxes can be compared. The most recent projections of the federal deficit from these agencies are presented in Chart 1. It is evident from a quick glance that the two agencies project strikingly different paths for the deficit over the remainder of the decade.

Neither agency constructs these projections as forecasts of future federal budget deficits, although the estimates frequently are interpreted in that fashion. The purposes of this *Letter* are to explain the difference between a budget forecast and budget projections, and to indicate why it is inappropriate to use the latter as forecasts.

Budget forecasts

In many discussions of the medium-term (next 3 to 5 years) economic outlook or of proposed changes in fiscal policy, the economic forecast employed is based upon a forecast of federal receipts, outlays, or the budget deficit. For example, some analysts assert that interest rates on long-term securities are presently high because lenders are forecasting large federal government budget deficits through the remainder of the decade and thus anticipate that the government will have to finance them. These analysts predict that this large future borrowing by the government will drive up future short-term interest rates.

Such statements implicitly are based upon a forecast of future federal budget deficits, that is, the best guess about the size of the deficits that will actually occur at future dates given the information available at the time that the forecast is constructed. Alternatively stated, the forecast of future deficits is the forecaster's judgment about the most likely values for deficits at future dates.

A true forecast of government receipts, outlays, and the budget deficit cannot be constructed independently of a forecast of economic activity. The forecaster must make assumptions about the most likely future size of government programs, future tax rates, future monetary policy and all other factors that are believed to influence economic activity. Based upon these assumptions, budget deficits must be forecast *simultaneously* with future economic activity.

There are two reasons that economic activity and budget deficits must be forecast together. The first is that federal outlays and receipts, and hence the budget deficit, are affected by the state of the economy. If the economy slides into a recession, federal tax receipts decline even if tax rates stay the same since the tax base upon which those rates are assessed, such as adjusted gross income or corporate profits, declines. Similarly, in a recession, certain federal government outlays, e.g., unemployment insurance and social service payments, rise.

The impact of a recession on federal government receipts and outlays is to increase the size of the observed deficit even though no explicit policy actions have been taken by the Congress or the President. Conversely, if the economy expands rapidly, and the rate of inflation increases, federal receipts and outlays typically increase as the cost of items purchased by the government increases and as inflation increases the size, in dollars, of the base on which taxes are levied.

These induced effects of the economy on the budget tend to cushion the economy's decline when it is weak and restrain the economy when it is strong. Hence, the frequent reference to the "automatic stabilizer" aspect of fiscal policy.

The second reason forecasts of the economy and the budget cannot be done independently is simply that the interaction between federal receipts and outlays and the economy is not a one-way street. Decisions by the Congress and the President to alter the amount of government purchases or the rate or base for various taxes affect the level of economic activity, at least in the short-run.

Budget forecasts vs. projections

The budget projections constructed by the CBO and the OMB are not forecasts as defined above. Instead of determining the future path of the economy and the future budget deficit simultaneously as required by a true forecast, these agencies *assume* a path of future economic activity and ask the question: what values will be realized for government outlays, receipts and the budget deficit if the assumed path of economic activity is to be realized and if government programs and tax rates are maintained at certain levels.

This technique does not guarantee consistency between the projections of economic activity and the assumed fiscal and/or monetary policy. In the words of the Congressional Budget Office: "These projections are not forecasts of the economy, based on assumptions about the maintenance of current policies. At times, the out-year projections have been viewed as goals while at other times they have incorporated average historical growth rates."

The contrast between the projection approach and a true forecast of future deficits can be seen in Chart 2 which gives the *economic assumptions* behind the CBO and OMB budget projections prepared last winter. Both agencies are required to make projections based on the same fiscal policy assumptions. CBO assumes an economic environment with less growth, more inflation, and higher market interest rates than the environment assumed by OMB. These differences in the assumptions about the path of the economy with the same policy settings are primarily responsible for the differences in the projections illustrated in Chart 1. In both cases, drastically different projections of future deficits could be produced by small alterations in the economic assumptions.

There is no basis for presuming that one set of assumptions represents a more likely path for economic activity than another. Indeed, the assumptions underlying both are suspect. The usual assumption is of relatively steady real growth over a five-year horizon. However, this horizon encompasses the average span of a typical peacetime business cycle in the U.S. In other words, a 5-year horizon often spans a period of considerable fluctuation in economic activity. Consequently, the underlying economic assumption of steady growth is often likely to be a poor forecast of the medium-term behavior of the economy. Because of such conditions, the budget projections are likely to be poor indicators of actual future budget deficits.

Current service concepts

Another reason that medium-term budget projections are apt not to represent future budget conditions is that they are typically constructed on a current services basis. Under the current services concept, future receipts and outlays are calculated under the unlikely assumption that the current laws and programs will remain unchanged.

Nondefense expenditures subject to the appropriations process are typically projected at their funding levels in the most recently completed fiscal year adjusted upward to keep pace with the projected rate of inflation. Defense expenditures have been treated differently at various times in the past within the current services budget concept. In the recent past, the CBO has prepared projections of defense expenditures based on the most recent Congressional Budget resolution. This builds substantial inflation-adjusted growth (5–6 percent per year) into the current projections of future defense spending, and, as a result, defense spending is projected to average in the range of 6.5 to 7.0 percent per year through 1990.

In contrast, OMB uses the Reagan administration's policy proposals for defense as the basis for its current services defense outlay projection. Under this definition, current services outlays for defense grow after adjustment for inflation as much as 10.6 percent in fiscal year 1986, but show inflation-adjusted growth declining to slightly over 5 percent per year in 1989 and 1990. These different treatments of defense spending result in a projection of $18 billion more in current services defense outlays by OMB in fiscal year 1990 than by CBO, even though the OMB projections assume lower future inflation rates than the CBO.

Conclusions

The medium-term budget projections prepared by the CBO and OMB are the results of a very precisely defined exercise. The rules of this exercise were constructed to provide a benchmark against which proposals for changes in outlays or taxes could be compared. These measures are not designed as, nor should they be interpreted as, forecasts of future federal outlays, receipts, or deficits.

Robert H. Rasche

Chart 1
Current Services Deficit Projections

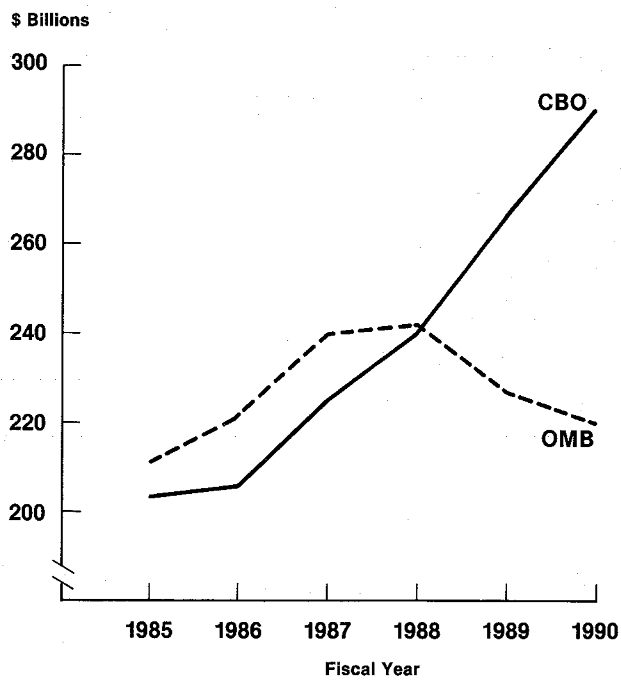
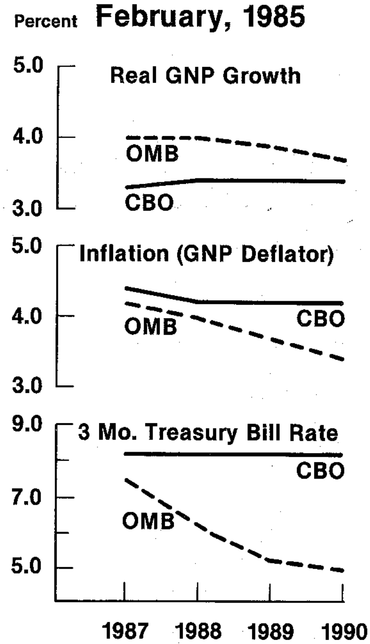


Chart 2
Economic Assumptions For Current Services Budget Projections February, 1985



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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 6/19/85	Change from 6/12/85	Change from 6/20/84 Dollar	Change from 6/20/84 Percent[7]
Loans, Leases and Investments[1 2]	191,879	274	11,175	6.1
Loans and Leases[1 6]	173,765	206	12,136	7.5
Commercial and Industrial	52,065	9	2,287	4.5
Real estate	63,303	157	2,870	4.7
Loans to Individuals	34,415	114	6,184	21.9
Leases	5,373	– 6	385	7.7
U.S. Treasury and Agency Securities[2]	11,181	103	– 783	– 6.5
Other Securities[2]	6,933	– 35	– 178	– 2.5
Total Deposits	197,061	– 325	9,747	5.2
Demand Deposits	46,750	– 182	2,325	5.2
Demand Deposits Adjusted[3]	30,562	– 670	2,215	7.8
Other Transaction Balances[4]	13,570	– 257	1,527	12.6
Total Non-Transaction Balances[6]	136,741	115	5,893	4.5
Money Market Deposit Accounts—Total	44,229	19	5,530	14.2
Time Deposits in Amounts of $100,000 or more	38,383	74	– 990	– 2.5
Other Liabilities for Borrowed Money[5]	23,967	3,095	211	0.8

Two Week Averages of Daily Figures	Period ended 6/17/85	Period ended 6/03/85
Reserve Position, All Reporting Banks		
Excess Reserves (+)/Deficiency (–)	76	– 3
Borrowings	11	32
Net free reserves (+)/Net borrowed(–)	65	– 35

1 Includes loss reserves, unearned income, excludes interbank loans
2 Excludes trading account securities
3 Excludes U.S. government and depository institution deposits and cash items
4 ATS, NOW, Super NOW and savings accounts with telephone transfers
5 Includes borrowing via FRB, TT&L notes, Fed Funds, RPs and other sources
6 Includes items not shown separately
7 Annualized percent change